No. 15434

In the United States Court of Appeals for the Ninth Circuit

AH PAH REDWOOD CO., A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF OF AMICI CURIAE

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BRIEF OF AMICI CURIAE

We file this brief as *amici curiae,* at the instance of California Forest Protective Association, Western Forestry and Conservation Association, Forest Industries Committee on Timber Valuation and Taxation, and National Lumber Manufacturers' Association, representing a substantial segment of the timber industry.

The brief is filed by written consent of all parties to the case. It is addressed to a matter which is of vital concern to the entire timber industry and which has been injected into this case by inadvertence. We refer to the point of law, decided by the Tax Court through mistake, that Sections 117(j) and 117(k)(2) of the Internal Revenue Code of 1939 do not apply to the disposal of timber held for sale to customers in the ordinary course of a taxpayer's trade or business.

Review of the Proceedings

At the outset, a short review of how this point happened to become involved in this case may be helpful to the Court.

Examination of the pleadings and briefs filed below makes it clear that the point was never put in issue by the parties below. The confusion of the Tax Court on the point apparently was a product of the practice there of filing simultaneous briefs.

In an effort to anticipate all possible argument by the taxpayer as to why capital gain was realized in the timber transaction involved in the case, in his principal brief in the Tax Court the Commissioner pointed out that "no evidence was submitted by . . . [the taxpayer] as to the purpose for which the . . . property was being held or whether such property was used in the taxpayer's trade or business." (Commissioner's Principal Brief, below, p. 14). It is perfectly clear from the context of these quoted remarks that they were designed to rebut a possible contention by the taxpayer that the timber was a *capital asset* so that capital gain would be realized under Section 117(a) of the Internal Revenue Code of 1939, even if it were determined that the transaction did not qualify for capital gain treatment under Sections 117(j) and 117(k)(2) of that Code. That this part of the Commissioner's argument was *not* directed at Sections 117(j) and (k)(2) is clearly shown by the language of the Commissioner's brief immediately following the above quotation:

> "However, since it was alleged in the petition that the timber was in the nature of a capital asset (Pet. ¶ V(1)), respondent assumes that the petitioner is attempting to show that the transaction falls within the scope of the timber provisions contained in section

117(k)(1) or (2) of the Internal Revenue Code as amended by the Revenue Act of 1943. If section 117(k)(1) or (2) is applicable, the timber involved is brought within the definition of 'property used in the trade or business of the taxpayer' by section 117(j) of the Internal Revenue Code as amended by the Revenue Act of 1943, and amounts received are treated as a sale of property used in a trade or business of the taxpayer for the purpose of section 117(j)."

Judging from language in the Tax Court's opinion, we surmise that what happened was that Judge Van Fossan telescoped the Commissioner's argument on the capital gains issue, and erroneously concluded that the Commissioner's reference to the taxpayer's failure to adduce evidence of the purpose for which it held the timber was directed at Sections 117(j) and (k)(2), which as it turned out were the only provisions on which the taxpayer relied. In any event, the Judge erroneously applied the trade or business test as a separate ground for holding that the taxpayer was not entitled to capital gain treatment under Sections 117(j) and (k)(2).

As indicated by the Record, the taxpayer filed a motion in the Tax Court for revision of that court's decision with respect to the scope of Sections 117(j) and (k)(2). However, before the Tax Court acted on such motion, the taxpayer apparently felt obliged to appeal to this Court to protect its right of appeal—thus leaving its motion for revision of the Tax Court's opinion undecided.

Faced with this published Tax Court opinion holding for him on a point for which he has never contended, and which is contrary to his long-established position, the Commissioner promptly took the commendable step of expressly disavowing the Tax Court opinion on this point (Rev. Rul.

57-90, I. R. B. 1957-10, 9).[1] The Commissioner's statement of his position in Rev. Rul. 57-90 is forthright and unequivocal. It should settle this matter for the future.

However, we are somewhat apprehensive that the Brief for Respondent filed by the Department of Justice may prove misleading to the Court in its statement of the Government's position on this point. Respondent's Brief not only lacks the forthrightness of the Commissioner's Revenue Ruling, but is open to the possible interpretation, whether intended or not, that there is some support in prior cases for the erroneous position taken by the Tax Court that capital gain treatment is not available under Sections 117 (j) and (k)(2) where the timber disposed of was held for sale to customers in the ordinary course of business. Since the taxpayer's Reply Brief does not discuss the cases cited on this point in the Brief for Respondent, we file this brief to do so.

Reply to Brief for Respondent

The Brief for Respondent quotes, out of context, a sentence from the opinion of the Court of Claims in *Boeing* v. *United States,* 98 F. Supp. 581 (Ct. Cls. 1951), in such a way as to leave the impression that the opinion lends sup-

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[1] "SECTION 631.—GAIN OR LOSS IN THE CASE OF TIMBER OR COAL (Also Section 1231) Rev. Rul. 57-90

"In the case of the disposal of timber, held for more than six months prior to such disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber, pursuant to the provisions of section 631(b) of the Internal Revenue Code of 1954, the gain or loss on such disposal is subject to the tax treatment provided by section 1231 regardless of the nature of the taxpayer's business or the purpose for which the timber is held. To the extent that the opinion in *Ah Pah Redwood Co.* v. *Commissioner*, 26 T.C. 1197, may be inconsistent with the foregoing, it does not represent the position of the Internal Revenue Service." (Rev. Rul. 57-90, I.R.B. 1957-10, 9-10)

port to the Tax Court's erroneous position on the question.[2] Nothing could be farther from the truth.

Although it was decided in 1951, the *Boeing* case in the Court of Claims involved taxes for the years 1936 and 1937. The Court of Claims was very careful to point out that although Section 117(k)(2) of the Internal Revenue Code of 1939 (enacted in 1943) was made retroactive back to 1913, Section 117(j) of the 1939 Code (enacted in 1942) was *not* made retroactive beyond 1942. Thus, Section 117(k)(2) applied to the years in controversy in the *Boeing* case then before the Court of Claims (1936 and 1937), and Section 117(j) did *not* apply to the tax years involved in that case. Thus the Court of Claims was faced with the problem of interpreting Section 117(k)(2) *without Section 117(j).*

As to Section 117(k)(2) *thus standing alone,* the Court of Claims stated:

> "The controlling law tells us only that (k)(2) gains are to be considered as gains upon sales of timber. It does not tell us expressly whether gains upon sales of timber are taxable as capital gains or as ordinary income. Even prior to the enactment of Section 117(k), the courts had held that the proceeds of a sale of timber to a logging company under a cutting contract were

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[2] The Brief for the Respondent, in footnote 2, pages 8-9 states:

"2 In the *Boeing* case, the Court of Claims concluded, after tracing the legislative history of Section 117(k)(2), that the taxpayer was entitled to capital gains treatment on the Greenwood contract (pp. 584-585)—

"unless perhaps it can be said that plaintiff was in the trade or business of selling timber to logging companies.

The court held that the taxpayer was not in the business of selling timber, but was merely liquidating an investment and, therefore, having otherwise qualified under Section 117(k)(2), was entitled to capital gains. See also *Willey* v. *Commissioner,* decided December 7, 1950 (1950 P-H T.C. Memorandum Decisions, par. 50,299), affirmed, 199 F. 2d 375 (C.A. 6th); *Commissioner* v. *Boeing,* 106 F. 2d 305 (C.A. 9th), certiorari denied, 308 U.S. 619."

> capital gains. United States v. Robinson, 5 Cir. 129 F. 2d 297; Estate of M. M. Stark, 45 B. T. A. 882. The decision in Commissioner of Internal Revenue v. Boeing, 9 Cir. 106 F. 2d 305, certiorari denied 308 U. S. 619, 60 S. Ct. 295, 84 L. Ed. 517, which defendant contends estops plaintiff here and which we discuss more fully *infra,* went against taxpayer because the court concluded that the contracts did not effect sales of timber. But the law now provides that they are to be considered as if they did." (98 F. Supp. at p. 584).

In other words, as the Court of Claims correctly pointed out, all that Section 117(k)(2) provides is that certain disposals of timber shall be treated as sales. It says nothing about how such sales are to be taxed. Therefore, since Section 117(j), which gives capital gains treatment to certain sales and exchanges of certain *non-capital* assets, was not applicable to 1936 and 1937, the court had to look to Section 117(a) to determine whether the 1936 and 1937 timber disposals of the taxpayer, which were to be treated as sales under Section 117(k)(2), were sales of *capital assets.*

It was in this setting that the Court of Claims used the following language which has been so misleadingly quoted out of context in the Brief for Respondent herein:

> "These, then, are capital gains unless perhaps it can be said that plaintiff was in the trade or business of selling timber to logging companies."

It is perfectly obvious that the above quoted remarks of the Court of Claims have reference only to Section 117(k)(2) standing alone without the necessary tie-in with Section 117(j). It also is perfectly obvious that whether the timber would be a capital asset under Section 117(a) would involve the factual question of whether it was held for sale to

customers in the ordinary course of business. The quoted remarks are thus no authority whatsoever for the Tax Court's opinion on the point. In fact, the full opinion of the Court of Claims in the *Boeing* case is contrary to the present Tax Court position, for the Court of Claims expressly stated that:

> "If 117(j) had *also* been made retroactive back to 1913, *then, of course, there would be no doubt that all (k)(2) gains would be taxable as capital gains.*" (Emphasis supplied) (*Boeing* v. *United States,* 98 F. Supp. 581, footnote 8, at page 584)

Besides the *Boeing* case, discussed above, the Brief for Respondent also refers to a prior *Boeing* case (*Commissioner* v. *Boeing,* 106 F. 2d 305 (9th Cir. 1939, cert. denied 308 U.S. 619 (1939)), involving taxes for the years 1933 and 1934. What the Brief for Respondent neglects to indicate is that this prior *Boeing* case was decided in 1939. Section 117(j) was not enacted until 1942, and Section 117(k)(2) was not enacted until 1943. This Court surely could not be thought to have construed or applied, in 1939, statutes which were not enacted until 1942 and 1943! This Court's opinion in that case has no possible bearing on the question now before it.

The third case cited on this point in the Brief for Respondent is *D. H. Willey,* 9 T.C.M. 1109 (1950), aff'd, 199 F. 2d 375 (6th Cir. 1952). That case did not even involve Sections 117(j) and (k)(2). It involved only Section 117 (a). The question presented was whether certain income received from the sale of timber was ordinary income under Section 22(a) or "gain from the sale of capital assets under section 117." The Commissioner argued that it was ordinary income since it constituted receipt of income from the sale of property held primarily for sale to customers in

the ordinary course of trade or business. The Tax Court pointed out that "Property so held is excluded from the definition of 'capital assets' in section 117(a)." The case was decided against the taxpayer for failure to meet his burden of proof. The Court of Appeals for the Sixth Circuit affirmed in a *per curiam* decision which merely stated in effect that the opinion of the Tax Court was being affirmed. There is thus nothing whatsoever in the *Willey* case to justify the reference thereto in the Brief for Respondent herein.

Legislative Construction

Since the taxpayer has briefed in detail the legislative and regulatory history of Sections 117(j) and (k)(2), there is no need for us to duplicate that effort here.

However, we do suggest that Section 117(j) is so clear on its face that there is no need to resort to its legislative history to determine its meaning. Mere reading of the Section requires the conclusion that all timber to which Section 117(k)(2) applies automatically qualifies for Section 117(j) treatment, regardless of whether such timber was held for customers in the ordinary course of trade or business.

Section 117(j)(1) contains the "Definition of property used in the trade or business" to which special capital gain and ordinary loss treatment is accorded by Section 117(j)(2). As applicable to the years in controversy in this case (1948-1949), it reads:

> "(j) GAINS AND LOSSES FROM INVOLUNTARY CONVERSION AND FROM THE SALE OR EXCHANGE OF CERTAIN PROPERTY USED IN THE TRADE OR BUSINESS—(1) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS.—For the purposes of this subsection, *the term 'property used in the trade or business'* means the property used in the trade or business, of a character which is subject

to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. *Such term also includes timber with respect to which subsection (k)(1) or (2) is applicable.*" (Emphasis supplied)

It is perfectly obvious that the words "Such term" in the second sentence refer only to *the term* being defined, namely, "Property used in the trade or business." It thus is clear that the "(A)" and "(B)" restrictions in the first sentence—with respect to inventories and property held primarily for sale to customers—do not apply to the second sentence, which contains the special definition of "property used in the trade or business" as respects "timber".

No other construction makes sense. If the limitations in the first sentence as to inventories and property held for sale to customers were intended to be incorporated by inference into the second sentence and thus apply to timber, the six months holding period requirement in the first sentence also would have to be deemed incorporated by inference into the second sentence and to apply to timber. This clearly was not intended, for Congress expressly provided different six month holding period rules for timber in Sections 117(k)(1) and (2) themselves. (In the case of Section 117(k)(1) the timber must have been held for more than six months *prior to the beginning of the year in which the timber is cut.* In the case of Section 117(k)(2) the timber must have been held for more than six months *prior to the disposal thereof.*) Thus any construction which applied the restrictions in the first sentence of Section 117

(j)(1) to timber to which subsection (k)(1) or (k)(2) applies would create insolvable conflicts between the six month holding period rules in 117(j)(1) and those in 117(k)(1) and (k)(2).

Furthermore, as noted, any construction which carries the inventory and property held for sale to customers restrictions of the first sentence of Section 117(j)(1) into the second sentence dealing with timber would require that such restrictions be applied to Section 117(k)(1) as well as to Section 117(k)(2), for the second sentence of Section 117 (j)(1) covers "timber with respect to which subsection (k)(1) or (2) is applicable." The "B" provision of the first sentence of Section 117(j)(1) *excludes* "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." On the other hand, Section 117(k)(1) by its explicit terms *applies* to timber held "for sale or for use in the taxpayer's trade or business." It is thus impossible to read into the second sentence of Section 117(j)(1) the limitations as to property held for sale to customers contained in the first sentence of such paragraph without creating further insolvable conflicts between Section 117(j)(1) and Section 117(k)(1).

Similar irreconcilable conflicts with certain 1951 amendments of Section 117(j)(1) would be created by any construction which carried the property held for sale to customers in the ordinary course of business limitation of the first sentence over into the second sentence of such Section. In the Revenue Act of 1951 Congress amended the second sentence of Section 117(j)(1) by adding a new provision at the end of the sentence assuring capital gain treatment of sales of "unharvested crops". Congress also added a third sentence ensuring capital gains treatment of sales of "breeding livestock."[3] The Treasury Department had

[3] These amendments also added "coal" to Section 117(k)(2) and to the second sentence of Section 117(j)(1).

been contending that unharvested crops and breeding livestock were held for sale to customers in the ordinary course of business and therefore were not entitled to capital gains treatment. The Committee Reports make it clear that the purpose of these Amendments was to settle the dispute and allow capital gains treatment.[4] Here, again, holding period requirements *different* from the six month holding period requirement of the first sentence of Section 117 (j)(1) were provided (12 months in the case of breeding livestock, *no holding period* in the case of unharvested crops). Thus, as in the case of timber covered by 117 (k)(1) and 117(k)(2), a construction of Section 117(j)(1) which, by inference, carries the first sentence limitations and requirements into the second sentence of Section 117 (j)(1) would create an irreconcilable conflict between the first sentence and the second sentence (both before and after the 1951 amendment) and between the first sentence and the third sentence (added by the 1951 amendment). The Commissioner's construction of the statute in Rev. Rul. 57-90 avoids all these problems.

There is nothing in Section 117(k)(2) itself to prevent its application to timber held for sale to customers in the ordinary course of trade or business. As already indicated in connection with the discussion of the *Boeing* case in the Court of Claims, *supra,* in effect all that Section 117(k)(2) says is that a *disposal of timber* qualifying thereunder is to be treated as a *sale of timber.* It is Sections 117(j)(1) and (2) which provide *how* that *sale* shall be treated. Section 117(j)(1) says that Section 117(k)(2) timber is "property used in the trade or business", and Section 117(j)(2) says that a sale of "property used in the trade or business", at a gain, is to be considered as the sale of a capital asset. This is what the Tax Court opinion overlooks—and it is the

[4] Report, Senate Finance Committee (82d Congress, 1st Sess., S. Rept. 781, p. 41-42 and 47-48); Conference Committee (82d Congress, 1st Sess., H. Rept. 1213, p. 78.)

key to the whole statutory pattern of the timber provisions in Section 117.

If there were any doubt at all about the correctness of the above interpretation of Section 117(j)(1) of the 1939 Code, it is removed by the manner in which the provision was recodified in the 1954 Code. In the 1954 Code the first and second sentences of Section 117(j)(1) of the 1939 Code have been placed in separately numbered paragraphs. The old first sentence is now labelled the "General Rule" and the old "A" and "B" special limitations as to inventories and property held for sale to customers have been placed in separate subparagraphs thereunder. (Section 1231(b)(1)(A) and (B), Internal Revenue Code of 1954.) The special rule as to timber previously contained in the second sentence of Section 117(j)(1) is now placed in a separately numbered paragraph, headed "Timber or coal" (Section 1231(b)(2), Internal Revenue Code of 1954). The special rules giving capital gain treatment to sales of breeding livestock and unharvested crops, which the Congress clearly intended were *not* to be treated as property held for sale to customers in the ordinary course of business, also were placed in separately numbered paragraphs (Section 1231(b)(3) and 1231(b)(4)). Any inferential construction carrying the property held for sale to customers restriction of the "General Rule" into these separately numbered paragraphs would defeat their very purpose.

The Committee Reports make it clear that these changes in the Internal Revenue Code of 1954 were merely editorial in nature and that no change in substance was intended. House Report No. 1337, 83d Cong., 2nd Sess., p. A275, contains the following report on section 1231:

> "*Section 1231. Property used in the trade or business and involuntary conversions.*
>
> This section is derived from section 117(j) of present law. *There is no substantive change intended but*

some rearrangement has been made.'' (Emphasis supplied)

Senate Report No. 1622, 83d Cong., 2d Sess. p. 433, contains the following report on such section:

''Section 1231. Property used in the trade or business and involuntary conversions.

This section corresponds to section 1231 of the bill as passed by the House but makes one amendment. It is derived from section 117(j) of present law. Subsection (b)(2) has been amended to apply to iron ore to which section 631(c) applies.'' [The amendment as to iron ore was deleted by floor amendment before the Bill passed the Senate.]

Conclusion

We respectfully submit that the Tax Court erred in holding that capital gains treatment is not available under Sections 117(j) and (k)(2) of the 1939 Code, where the timber disposed of was held for sale to customers in the ordinary course of business.

Respectfully submitted,

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